

DOCUMENT RESUME

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Relationships between Nonprofit Prepaid Health Plans with California Medicaid Contracts and For-Profit Entities Affiliated with Them. December 15, 1976. 9 pp.

Testimony before the Senate Committee on Government Operations: Permanent Investigations Subcommittee; by Edward A. Densmore, Jr., Associate Director, Human Resources Div.

Issue Area: Health Programs (1200).

Contact: Human Resources Div.

Budget Function: Health: Health Care Services (551).

Organization Concerned: Consolidated Medical Systems, Ltd.;

Harbor Health Service; Family Health Program, Inc.; American Health Care Plan, Inc.; Omni-Rx Health Care, Inc.

Congressional Relevance: Senate Committee on Government Operations: Permanent Investigations Subcommittee.

Authority: Knox-Hills Health Plan Act. Social Security Act, sec. 1861(o). Internal Revenue Code, sec. 501(c).

The relationships of nonprofit health plans under California Medicaid contracts with their affiliated profitmaking firms were studied. Government programs that allow contracting only with nonprofit corporations, the existence of overlapping interests, and difficulties in auditing corporations with complex interrelationships were investigated. Five of the plans studied had extensive contractual relationships with affiliated firms for services and facilities. Affiliations consisted of common directors, officers, and/or owners. The relationships were established in the belief that California prepaid health plans were required to be organized as nonprofit firms. From previous studies, it was concluded that it was not practicable to prohibit overlapping interests, but that public disclosure would be helpful. Audits of corporations with complex structures would involve many sets of records at great costs. Some changes could be made to the Internal Revenue Code to curb establishment of such organizational interrelationships. Nonprofit firms that receive Federal funds could be required to prepare consolidated financial statements covering affiliated firms. (HTW)

00520

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
Expected 10:00 a.m.
Wednesday, December 15, 1976

STATEMENT OF
EDWARD A. DENSMORE, JR., ASSOCIATE DIRECTOR
HUMAN RESOURCES DIVISION
BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON GOVERNMENT OPERATIONS
UNITED STATES SENATE
ON
RELATIONSHIPS BETWEEN NONPROFIT
PREPAID HEALTH PLANS WITH CALIFORNIA
MEDICAID CONTRACTS AND FOR PROFIT
ENTITIES AFFILIATED WITH THEM

We are pleased to be here today to testify on the November 1, 1976, staff study we prepared at the Subcommittee's request on the relationships between nonprofit prepaid health plans with California Medicaid contracts and for profit entities affiliated with them. We reviewed the corporate structures of five prepaid plans; Consolidated Medical Systems, Ltd; Harbor Health Service; Omni-Rx Health Care, Inc.; Family Health Program, Inc.; and American Health Care Plan, Inc. Four of these plans are based in Los Angeles, California, and the American Health Care Plan is located in San Francisco. All of these plans have been granted tax exempt status under section 501(c)(4) of the Internal Revenue Code.

The information in the staff study, and that which we present today relating to the study, was obtained primarily from documents given to us by the prepaid plans. We did not attempt to verify the information contained in the documents provided to us.

For the purpose of our study, we considered firms to be affiliated with a prepaid plan if they were connected by common directors, officers, and/or owners. The Federal Medicaid law does not define or deal with affiliated organizations; however, the firms we considered affiliated would also be so classified under the definition included in California's prepaid health plan contracts and under the "related organizations" concept included in the principles of reimbursement⁺ used under title XVIII of the Social Security Act--Medicare.

Our study showed that each of the five prepaid plans had extensive contractual relationships with affiliated firms. Consolidated Medical Systems and Omni-Rx Health Care contracted with affiliates for virtually all of the services required by their Medicaid contracts. Harbor Health Service contracted with affiliated firms for administrative services, facilities, and many of the required medical services. Family Health Program contracted with affiliated firms for the buildings it occupied, for medical equipment, and for a mountain cabin and a boat. American Health Care Plan contracted with affiliated firms for physician services.

We asked the prepaid plans why the elaborate corporate structures and interrelationships had been established. Omni-Rx replied that it believed that the Knox-Mills Health Plan Act, which governs all California prepaid health plans--whether or not they contract with Medicaid--required prepaid plans to be organized as nonprofit firms. Harbor Health Service said it believed the State Attorney General's interpretation was that for-profit corporations could not contract as prepaid plans with the State unless

professional corporations. Consolidated Medical Systems said that the State had indicated that it strongly preferred to contract with non-profit corporations. Therefore, the nonprofit prepaid plans were incorporated as a vehicle through which the for-profit firms could obtain Medicaid business.

One prepaid plan, Family Health Program, told us that its affiliated firms were established to provide a mechanism for obtaining the capital needed to provide the facilities it required. Family Health Program officials said that it was difficult to obtain financing on its own because it was a nonprofit corporation and commercial lending institutions did not want to make loans to nonprofits. However, we noted that Family Health Program had loaned affiliated firms more than \$1.2 million and had capitalized its insurance subsidiary with \$1 million. This indicates the Family Health Program had substantial funds available.

We obtained financial data from the prepaid plans and their affiliated firms to determine the profit/loss position of the affiliates. Some of this data had been audited by independent accounting firms, but most of it had not been audited. We did not attempt to audit the financial data ourselves. While data was not available to determine the profit or loss of all affiliates the data we obtained showed widely varying profit/loss percentages. These ranged from a before tax profit of 58.9 percent of revenues to a loss of 47.4 percent of revenues. Based on the data obtained, we cannot make a general statement about the profitability of the contractual agreements between prepaid plans and their affiliates, particularly under circumstances where there are accounting losses, but principals

withdrew in one year as much as 37 percent of their original investment apparently from the cash flow generated by the use of accelerated depreciation.

Mr. Chairman, you asked whether there were Government programs that allow contracting only with nonprofit corporations. Some examples are: contracts and grants under the Emergency School Aid Act (title VII of P.L. 92-318) as amended, and under certain sections of title IV of the Elementary and Secondary Education Act of 1965, as amended; and contracts and grants for foster child care under 42 U.S.C. 608 title IV of the Social Security Act. Under each of these programs, contracts are permitted only with nonprofit and public agencies. Also, under the Medicaid program, a number of States including Pennsylvania and Arkansas allow contracting for insurance-type contracts only with nonprofit and public agencies. In addition, Medicare's definition of a home health agency, contained in section 1861(o) of the Social Security Act, provides that for-profit home health agencies cannot participate in Medicare unless they are licensed under State law and meet such additional standards as may be prescribed in regulations. Under present regulations, in order to participate in Medicare, a for-profit home health agency must directly provide all of the services it offers and be licensed under State law, in addition to meeting all of the requirements for nonprofit agencies. If a State does not have a home health agency licensure law, for-profit agencies operating in that State cannot participate in Medicare. Furthermore, in order to participate in Medicaid, home health agencies must meet Medicare requirements.

You also asked if we have found, in other reviews, self-dealing situations involving directors of nonprofit corporations and for-profit firms owned or controlled by the directors. In an April 1975 report to the Congress, we discussed overlapping interests of members of hospital governing and advisory boards, mainly nonprofit hospitals. Some members of these boards were associated with firms doing business with the hospitals. Although not necessarily analogous to the interrelationships associated with the prepaid plans we studied, we found arrangements involving overlapping interests at 17 of the 19 hospitals we reviewed. The most frequent arrangement involved governing and advisory board members who were associated with banking, investment, or law firms serving the hospitals. At 14 of the 19 hospitals, at least one board member was connected with such a firm. Also, board members at three hospitals were associated with insurance companies doing business with the hospital. Other financial transactions included some with construction firms, financial and data processing companies, and drug, bedding, electrical, and plumbing suppliers, with which board members were associated.

We concluded that prohibiting the types of overlapping interests discussed above was not practicable. However, since such arrangements were common, we concluded that public confidence in the hospitals might be enhanced if the issue of overlapping interest was faced openly through public disclosure, including a statement of the extent of competition involved in acquiring goods and services.

In a report issued in May 1974, we discussed dealings between the Health Maintenance Organization of South Carolina, Inc. a nonprofit

corporation, which received grant funds under section 314(a) of the Public Health Service Act, and for-profit firms in which corporate officers of the health maintenance organization (HMO) had interests. The HMO paid salaries to employees of an affiliated firm (Management Systems, Inc. of South Carolina) who performed no work for the HMO. The HMO also sublet office space and sold furniture and equipment to this affiliated firm at less than the cost to the HMO. In addition, the HMO contracted with this affiliated firm for computer software, contracted with another affiliated firm for a paging service, and employed as a consultant one of the persons who incorporated an affiliate. The HMO also made loans to its officers and appeared to have paid excessive compensation to the officers.

Another report, issued in July 1976 to the Subcommittee on Health, Senate Committee on Finance, discussed the relationship between a nonprofit drug insurance company (PAID Prescriptions, Inc.), a data processing firm (Health Application Systems, Inc. (HAS)), and a manufacturer of health products and leading drug distributor (Bergin Brunswig Corporation).

HAS is a wholly owned subsidiary of Bergin-Brunswig. PAID is a California not-for-profit corporation which has been granted tax exempt status under section 501(c)(4) of the Internal Revenue Code and which either has, or until recently had, insurance-type contracts for Medicaid with Arkansas, California, Florida, Maine, North Carolina, and Pennsylvania to administer their Medicaid drug programs on a prepaid, capitation basis. HAS and PAID, and their predecessor organizations, have been affiliated since 1969 in a series of agreements which have given HAS increasing control over PAID.

At the time of our review, the agreement between HAS and PAID covered the period September 1, 1974, through December 31, 1993, and was renewable for two additional 10-year periods at HAS' option. Under this agreement, HAS has an exclusive right to promote, market, and use PAID's data service programs. All PAID contracts must be approved by a committee consisting of three PAID representatives and three HAS representatives. Until April 1976 the president of HAS cast the deciding vote if the contracting committee vote was a tie. On April 2, 1976, the deciding vote was given to the president of PAID.

The agreement between the two firms provided that PAID was to pay HAS, for claims processing a percentage of all the premiums PAID received, except for the North Carolina drug contract under which HAS received \$135,000 per month.

In a review of the foster child care program under title IV of the Social Security Act--Aid to Families with Dependent Children--we found several instances of nonprofit firms having dealings with for-profit firms owned or controlled by principals of the nonprofit firms. One firm which was granted tax exempt status under section 501(c)(3) of the Internal Revenue Code paid rent to an affiliated firm which represented about 30 percent of the market value of the leased property. Rent paid to firms not affiliated with the nonprofit firm represented between 11 and 14 percent of the market value of the leased property. Also, the nonprofit firm loaned money to another for-profit affiliate. The loans were for 10-year periods, were interest free, did not require collateral, and had no payment schedule.

You also asked whether there are difficulties in auditing corporations with the types of interrelationships described in our staff study. None of us here have ever been personally involved in a financial audit of a corporation with an elaborate structure like those depicted in the staff study. The main difficulty we foresee in auditing such firms is the number of different sets of books which must be audited in order to consolidate intercompany profits and losses and other types of intercompany transactions. An example of this relates to Omni-Rx Health Care, one of the prepaid plans we reviewed. In July 1976, Omni-Rx Health Systems, which controls Omni-Rx Health Care, told us that the complex intercompany agreements between the nonprofit plan and the for-profit affiliates required nine separate sets of accounting books and records. Also, HMO International, which controlled Consolidated Medical Services and the affiliated firms it contracted with, hired an accounting firm to conduct for HMO International and the affiliates a detailed audit of fixed assets and of financial transactions among the affiliates and HMO International. We were told that this audit cost HMO International about \$910,000 and lasted from May 1975 to September 1976.

You also asked for any suggestions we might have which would help curtail the establishment of complex corporate structures such as those used by the prepaid health plans. All of the prepaid plans studied, and some of the other entities previously discussed were granted tax exempt status under section 501(c) of the Internal Revenue Code. Although we have not thoroughly studied the matter, we believe that changes to section 501(c) could be made which could curb the establishment of

organizational interrelationships like those used by the prepaid plans. We understand that representatives of the Internal Revenue Service will discuss this matter with you later today.

Another action which we believe could be taken to curb these interrelationships is requiring that nonprofit firms that contract or receive grants under Federal or Federal/State programs be required to prepare consolidated financial statements covering all affiliated firms. Such a requirement, in view of the cost of implementing it, could help discourage the use of complex corporate structures and contractual interrelationships. Also, consolidated financial statements should provide a clearer picture of the true costs and results of operations, including overall administrative costs and profits.

Mr. Chairman, this concludes our statement. We have brought with us, at the suggestion of Subcommittee staff, blow-ups of six of the charts included in the staff study. At this time, we would be happy to explain these charts and answer any questions you may have.

NOTICE OF HEARING

Legislative Digest
PM 5445 A

COMMITTEE : Permanent Subcommittee on Investigations
Senate Committee on Government Operations

SUBJECT : Corporate structures of the prepaid health plans

DATE : Wednesday, December 15, 1976

TIME : 10:00 a.m.

ROOM : 3302 - Dirksen Senate Office Building

Membership : Sam Nunn (D-Ga.), Acting Chairman

Majority : (6-D) Senators Jackson, McClellan, (Ark.), Allen (Ala.),
Nunn (Ga.), Chiles (Fla.) and Glenn (Ohio)

Minority : (4-R) Senators Percy (Ill.), Javits (N.Y.), Roth (Del.)
and Brock (Tenn.)

Principal staff : Howard Feldman, Chief Counsel
David Vienna, Staff Investigator

GAO witness : Edward Densmore, Associate Director, Human Resources
Division

Accompanied by : Robert Iffert, Assistant Director, Human Resources
Division
Thomas Dowdal, Supervisory Auditor, HRD
M. Thomas Hagenstad, Legislative Adviser, Office of
Congressional Relations

One Car will leave G Street, 1st Basement, at 9:45 a.m.



M. Thomas Hagenstad
Legislative Adviser